STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
CLASSIC RESIDENCES, INC.	:	DETERMINATION DTA NO. 810986
for Revision of a Determination or for Refund of Tax on Gains Derived from Certain Real Property Transfers under Article 31-B of the Tax Law.	:	

Petitioner, Classic Residences, Inc., formerly known as Raynes Conversions, Inc., 551 Madison Avenue, New York, New York 10022, filed a petition for revision of a determination or for refund of tax on gains derived from certain real property transfers under Article 31-B of the Tax Law for the year 1987.

Petitioner, by its duly appointed attorney and representative, Margolin, Winer & Evens (James L. Tenzer, Esq., of counsel) and the Division of Taxation, by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel), signed a waiver of hearing last dated June 3, 1993 and consented to have the matter determined based upon filed exhibits and briefs. Under the terms of the waiver of hearing, the Division of Taxation was to file its list of exhibits by July 5, 1993. Petitioner had until August 6, 1993 to submit its exhibits, at which time the record was closed. Both parties filed briefs and exhibits. The last brief, petitioner's reply, was filed August 13, 1993. In addition to the exhibits it filed earlier, petitioner attached additional exhibits to its reply brief. After due consideration of the evidence and briefs filed herein, Carroll R. Jenkins, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether certain interest charges denominated by petitioner as "conversion period interest", could properly be included in the calculation of petitioner's original purchase price where there was no evidence that the underlying loans and interest, were customary, reasonable and necessary expenses incurred to create ownership interests in cooperative form.

II. Whether petitioner should be entitled to include special additional mortgage recording tax (Tax Law § 253 [1-a]) of $7,000.00 in the calculation of original purchase price even though it could have applied for a credit for this portion of the tax.

III. Whether petitioner has established that it incurred expenses for market surveys and miscellaneous conversion costs in the amount of $2,036.00, which it is entitled to include as part of its original purchase price.

IV. Whether petitioner has established that penalties asserted for failure to correctly report and remit the gains tax due should be abated.

FINDINGS OF FACT

Petitioner, Classic Residences, Inc., formerly known as Raynes Conversions, Inc., is the sponsor of the plan to convert 225 East 73 Street, New York, New York ("the property"), consisting of 88 apartment units, to cooperative ownership.

In August 1987, prior to the initial closing of the sale of apartment units, petitioner, as transferor, filed a Real Property Transfer Gains Tax Questionnaire for Cooperative and Condominiums (Form DTF-701) (hereinafter "Transferor's Questionnaire") with the Division of Taxation ("Division"). This form reported the anticipated transfer of apartment units at the property under "safe harbor" guidelines discussed, infra. Petitioner reported the actual anticipated "gross consideration" for the 54 units having pending contracts of sale, representing 14,778 shares of stock in the cooperative, and the "safe harbor" "gross consideration" (50 percent of the actual sales price of units sold vacant to "outsiders") for the 34 unsold units, representing 8,218 shares of stock in the cooperative.

Petitioner uses the term "conversion period interest" in its brief. Petitioner states that it had conversion period interest of $345,724.00. This figure, petitioner states, represents its total interest expense incurred in connection with all amounts borrowed to convert the property to cooperative ownership (Petitioner's Brief, p. 7).

The Real Property Transfer Gains Tax Schedule of Original Purchase Price for

Cooperatives and Condominiums (DTF-700) (hereinafter "Gains Tax Schedule") filed by petitioner sets forth the costs it included in computing its original purchase price for the property. Toward the bottom of the attached supplemental worksheet (DTF-703), under the heading "Additional Conversion Costs", petitioner reported conversion period interest of $345,724.00. This figure was transferred to, and reported on, the gains tax schedule (DTF-700) at page 2, Part IV, line 10 as part of the $848,535.00 (Actual) and $293,201.00 (Anticipated) in "Other conversion Costs". The $345,724.00 in conversion period interest is also reported on page 1, line 7 of petitioner's real property gains tax questionnaire (DTF-701) as a part of the conversion costs reported on that line.

The gains tax schedule (DTF-700) (at page two, line 26) referred to in Finding of Fact "7", reflects that petitioner also reported as part of original purchase price, $282,865.00 in "Interest paid during the construction period on loans where the proceeds of such loans were used to make capital improvements" (emphasis added). This figure is in addition to the interest charges of $345,724.00 described in Finding of Fact "3".

In the course of converting the property to cooperative use, a total of $628,589.00 in interest charges was incurred, all of which was included by petitioner in computing its original purchase price reported to the Division. Of this amount, $282,865.00 related directly to loans used to make capital improvements to the property (Finding of Fact "5"), and $345,724.00 related to loans used for other unspecified purposes.

Total mortgage recording tax reported by petitioner as part of its original purchase price was $63,000.00, of which $7,000.00 was attributable to special additional mortgage recording tax (hereinafter "SAMRT").

The gains tax questionnaire petitioner prepared and filed with the Division reported a negative "Gain Subject to Tax" of ($46,152.00) computed as follows:

Anticipated Gross consideration under "safe harbor"	$13,424,670.00
Less: Brokerage Fees	(535,921.00)
Anticipated Consideration	$12,888,749.00
Less: Original Purchase Price	(12,934,901.00)
Gain Subject to Tax:	($ 46,152.00)

Petitioner's gains tax questionnaire was the subject of a field examination conducted by the Division. On April 24, 1990, upon completion of the field examination, the Division issued a Statement of Proposed Audit Adjustment asserting additional gains tax due in the amount of $19,346.49, computed as follows:

Anticipated Gross Consideration:	$13,401,420.00
Less: Brokerage Fees	(535,921.00)
Anticipated Consideration:	$12,865,499.00

Original Purchase Price:	$12,934,901.00	
Disallowed:		
1) Conversion period Interest	(345,724.00)	
2) Special Additional Mgt. Recording Tax ($2,930,000 X .25%)	(7,000.00)	
3) Interior Designer Fees	(7,750.00)	(12,574,427.00)
Anticipated Gain		$ 291,072.00
Anticipated Tax at 10%		$ 29,107.00
"Tax due per audit" on 56 units sold as of the date of the Statement of Audit Changes		
(29,107 X 15,284 shs/22996 shs)		$ 19,346.49
Interest		$ 5,675.10
Penalty		$ 6,771.27
"Pay this Amount"		$ 31,792.86

On August 3, 1990, the Division issued a Notice of Determination to petitioner asserting additional real property gains tax ("gains tax") due in the amount of $19,346.49 plus penalty and interest. At petitioner's request, a conciliation conference was held by the Bureau of Conciliation and Mediation Services. At this conference petitioner produced documentation in support of its claimed architectural fees of $7,750.00. These fees were allowed by the conferee, and the resulting Conciliation Order dated April 10, 1992 reduced the tax asserted to $18,829.89 plus penalty and interest. This is the amount remaining in dispute.

SUMMARY OF THE PARTIES' POSITIONS

As noted earlier, petitioner states that "conversion period interest" of $345,724.00 represents the total interest expense incurred by it from inception in connection with all amounts borrowed to convert the property to cooperative ownership.

Petitioner argues that since it has been in the process of converting the property to cooperative ownership from the inception, the entire amount of its interest expense on funds borrowed to convert the property "represents part of the economic cost of the conversion and, in theory and economic substance, is not dissimilar to construction period interest expense incurred by someone on funds borrowed to construct property" (Petitioner's Brief, p. 7).

With regard to the SAMRT ($7,000.00) which the Division disallowed as an expense that could be included in computing original purchase price, petitioner argues that the entire

amount of the mortgage recording taxes it paid ($63,000.00) should have been allowed. The Division argues that petitioner could have claimed a credit or refund for that portion of the mortgage recording tax which was SAMRT ($7,000.00), and therefore, SAMRT could not be included in computing original purchase price.

Petitioner also urges that penalties should be abated since it filed the subject gains tax questionnaire and schedules in a timely manner, and its failure to pay the tax now asserted by the Division was based on a reasonable legal interpretation of Tax Law Article 31-B.

Petitioner's brief (p. 11) states that it incurred expense for market surveys and miscellaneous conversion costs in the amount of $2,036.00, and is entitled to have these costs included as part of its original purchase price.

CONCLUSIONS OF LAW

A. Tax Law § 1441 imposes a tax on gains derived from the transfer of real property at the rate of 10% of the gain. For purposes of computing the tax, a cooperative conversion is treated as a single transfer; however, the payment of tax is due upon the transfer of shares to individual purchasers pursuant to a cooperative plan (Tax Law § 1442[b]; see, Matter of Mayblum v. Chu, 67 NY2d 1008, 503 NYS2d 316). In computing the amount of tax due as each share is sold, an apportionment of the original purchase price of the real property and total consideration anticipated under such cooperative plan shall be made for each share (Tax Law § 1442[b]).

B. On August 22, 1983, the Division set forth two options, A and B, to estimate gain on cooperative and condominium plans (TSB-M-83-[2]-R). Under Option A, the actual consideration paid for each share with an apportionment of the total original purchase price to each share determined the gain subject to tax as each share sold. Under Option B, the total anticipated consideration less the total anticipated original purchase price determined the gain subject to tax as each share sold. By selecting Option B, the taxpayer was permitted to pay the estimated tax rate, even though the actual consideration received may have been greater when the shares actually sold. Once the number of sales reached the 25%, 50% and 75% levels, a new tax rate per share was determined based on actual consideration received plus estimated

consideration for the remaining unsold shares. At the 100% sell-out point, any underpayments or overpayments based on the actual consideration received for the total number of shares sold would be adjusted accordingly. Thus, in contrast to Option A, Option B was less cumbersome to administer to the extent that, as units were sold, it was not necessary to recalculate the amount of tax owed based on the actual consideration received, as well as other costs, for each unit.

In 1986, the Division eliminated Option A as a method of paying the tax and directed that the new method for paying the tax would be a modified Option B (TSB-M-86-[2]-R). Under the new Option B, updating was optional at the 25% plateau and guidelines were provided for determining "safe harbor estimates" of anticipated taxes such that, in the event of underpayments, there would be no imposition of penalty or interest on the underpayments (TSB-M-86-[3]-R). In effect, if the safe harbor estimates were lower than the actual selling price, then the taxpayer received the benefit of postponing the full amount of tax owed based on actual consideration. If the safe harbor estimates were greater than the actual selling price, then the taxpayer would be entitled to a lower tax rate for the remaining unsold shares when recalculated at the 50% and 75% plateaus or to a refund at the 100% sell-out point.

C. Tax Law § 1440(5)(a) provides as follows:

> "'Original purchase price' means the consideration paid or required to be paid by the transferor; (i) to acquire the interest in real property, and (ii) for any capital improvements made or required to be made to such real property, including solely those costs which are customary, reasonable, and necessary, as determined under rules and regulations prescribed by the tax commission, incurred for the construction of such improvements. Original purchase price shall also include the amounts paid by the transferor for any customary, reasonable and necessary legal, engineering and architectural fees incurred to sell the property and those customary, reasonable and necessary expenses incurred to create ownership interests in property in cooperative or condominium form, as such fees and expenses are determined under rules and regulations prescribed by the tax commission."

20 NYCRR 590.39 states as follows:

> "Question: What are the allowable costs of co-oping (or converting property to condominium form) if paid or required to be paid by realty transferor?
>
> "Answer: The following list illustrates costs that are includible in original purchase price as costs to convert property to cooperative or condominium form:

- legal, accounting and engineering fees incurred directly as a result of cooperative or condominium formation and transfer of title to the cooperative corporation
- filing and recording fees
- costs of printing offering plan
- title insurance
- New York City Real Property Transfer Tax paid as a result of conveyance of title to the cooperative corporation
- New York State Real Estate Transfer Tax paid as a result of conveyance to the cooperative corporation
- appraisal fees
- mortgage recording tax on mortgages created as a result of conveyance of title to the cooperative corporation
- mortgage commitment fees
- points paid to lender
- the cost of 'buying down' the interest rate on co-op loans to purchasers
- the cost of 'buying out' nonpurchasing tenants
- amounts paid to relocate nonpurchasing tenants"

D. A taxpayer's original purchase price in the property goes to reduce the amount of its taxable gain. Petitioner contends that, in the computation of its original purchase price, its conversion period interest and special additional mortgage recording tax should have been allowed as items to be included in computing its original purchase price.

E. Petitioner argues that since it has been involved in converting the property to cooperative ownership from inception:

> "[T]he entire amount of its interest expense on funds borrowed to convert the property represents part of the petitioner's economic cost of the conversion and, in theory and economic substance, is not dissimilar to 'construction period interest' expense incurred by taxpayers on funds borrowed to construct property" (Petitioner's Brief, p. 7).

This argument ignores that Tax Law § 1440(5) limits the costs that can be included in original purchase price to those which are "customary, reasonable and necessary" as determined "under rules . . . prescribed by the tax commission." The applicable rules (20 NYCRR 590.39) do not provide for including the "entire interest expense on funds borrowed to convert" property to be included in original purchase price. Petitioner's analogy of construction period interest expense to conversion interest expense is even more tenuous, given that the former creates new property which is then placed in service and the latter simply changes the form of ownership of property. An argument similar to that of petitioner's was recently rejected by the Tax Appeals Tribunal (see, Matter of 61 East 86th Street Equities Group, Tax Appeals Tribunal, January 21,

1993); Matter of Mattone v. State of New York Dept. of Taxation & Fin., 144 AD2d 150, 534 NYS2d 478 [3d Dept 1988]).

F. Petitioner also argues that "conversion period interest" of $345,724.00 represents the total interest expense incurred by petitioner "in connection with all amounts borrowed to fund amounts paid to convert the property" to cooperative ownership (Petitioner's brief, p. 7). That is clearly not the case.

Based on the figures reported by petitioner on its gains tax schedules and transferor questionnaire, petitioner incurred total interest charges of $628,589.00 arising from funds borrowed in connection with the conversion of this property to cooperative ownership (see, Findings of Fact "4", "5" and "6"). On the gains tax schedules filed with the Division, petitioner reported interest charges of $282,865.00 which it stated were directly related to loans used to create capital improvements to the property. These interest charges were properly allowed by the Division to be included in petitioner's computation of original purchase price since they were directly related to capital improvements made or required to be made to the property (Tax Law § 1440[5][a][ii]). However, petitioner also reported "conversion period interest" of $345,724.00 on these same forms, which amount was disallowed by the Division as not properly includible in computing original purchase price.

Tax Law § 1440(5)(a) limits costs includible in original purchase price to, inter alia, those which are "customary, reasonable and necessary as determined under rules . . . prescribed by the tax commission" and "incurred to create ownership interests in property in cooperative form" (emphasis added). The crucial question here is whether petitioner has shown that the loan proceeds giving rise to the conversion period interest were customary, reasonable and necessary expenses used "to create ownership interests in cooperative form" (Matter of 1230 Park Assoc., Tax Appeals Tribunal, July 27, 1989, confirmed sub nom Matter of 1230 Park Assoc. v. Commissioner of Taxation and Finance, 170 AD2d 842, 566 NYS2d 957, lv denied 78 NY2d 859, 575 NYS2d 455).

Petitioner presented no evidence to show the purposes for which the loans giving rise to

the "conversion period interest" were used. Accordingly, there is no evidence to show if, or to what extent, the loan proceeds upon which the conversion period interest accrued, were "customary, reasonable and necessary" or used to "create ownership interests in property in cooperative form".

Petitioner submitted copies of its cancelled checks with its reply brief, after the record in this matter had been closed. These cancelled checks purport to show petitioner's interest payments made to various entities on loans used in converting the property. These cancelled checks were not timely filed and were not made part of this record.[1] Even

if these checks had been made part of the record, however, they would have had no impact on the result, since they are probative of nothing other than that petitioner incurred interest expenses. The cancelled checks provide no evidence whatever as to how the proceeds of the underlying loans were used in the course of converting the property. In the absence of such evidence, petitioner has failed to carry its burden to show that the funds were used for "customary, reasonable and necessary expenses incurred to create ownership interests in

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[1]I will not permit actions by a petitioner which, if done by the Division, I would prohibit. The tactic of using briefs as a mechanism to offer evidence after the record has been closed would, if permitted, result in chaos. Every proceeding in the Division of Tax Appeals has an evidentiary stage and a briefing stage. Here, the parties decided for themselves the time period within which evidence could be submitted, at which point the record was closed and the briefing stage began.

A party cannot wait until briefs are filed to see what arguments the opponent will make and then use its brief to put in evidence which responds to the opponent's arguments. In this case, the Division filed its brief arguing, inter alia, that petitioner had offered no proof that it had actually made the claimed interest payments. Petitioner then filed its reply brief with copies of cancelled checks showing interest payments. If a petitioner were permitted to do this, then a similar courtesy would be required to be extended to the Division. Of course, both sides would want additional opportunities to respond, in turn, to the new evidence and arguments of the other. Then the new arguments would offer an opportunity for yet more new evidence in response.

If, after the period for submitting evidence has expired, a party wishes to submit additional evidence, an application to reopen, on notice to his/her opponent, is the appropriate and the only fair manner of proceeding. In most cases, such an application would be granted, but only when done upon notice.

property in cooperative . . . form." The Division's refusal to include the $345,724.00 in conversion period interest in its computation of original purchase price was proper.

G. The next question is whether petitioner was entitled to include the $7,000.00 in SAMRT in computing its original purchase price. Section 1440(5)(a) also provides that "customary, reasonable and necessary" costs are those "determined under rules and regulations prescribed by the tax commission . . . ." Thus it is within the exclusive power of the Commissioner of Taxation and Finance to prescribe by regulation those costs properly includible in computing original purchase price.

As noted earlier, 20 NYCRR 590.39 provides for what the Commissioner of Taxation and Finance has determined by regulation to be "customary, reasonable and necessary" costs of converting property to cooperative ownership if paid or required to be paid by the transferor. Among the items

that this regulation provides are includible in original purchase price as a cost to convert property to cooperative or condominium form is:

> "mortgage recording tax on mortgages created as a result of conveyance of title to the cooperative corporation."

Thus, the Commissioner of Taxation and Finance has promulgated a regulation which expressly provides that mortgage recording tax is includible in computing original purchase price.

The Division states that petitioner could have taken a tax credit for the amount it paid as SAMRT, and accordingly, SAMRT "[i]s not an expense, 'incurred to create ownership interests in property in cooperative form . . .'" (citing Tax Law § 1440[5][a]) (Division's Brief, p. 5). This "policy" appears to be at odds with the Commissioner's regulation, supra.

The Commissioner's own regulations expressly make provision for the inclusion of mortgage recording tax in computing original purchase price. The Commissioner could have expressly provided that mortgage tax, except for SAMRT, can be included in computing original purchase price. No such exception or distinction was made. SAMRT is a mortgage recording tax. Since the Commissioner's own rules and regulations provide that mortgage

recording tax can be included in computing original purchase price, the Division erred in not permitting petitioner to include this tax in original purchase price.

H. Petitioner's brief (p. 11) states that it incurred expenses for market surveys and miscellaneous conversion costs in the amount of $2,036.00 and it is therefore entitled to have these costs included as part of its original purchase price. Petitioner raised this issue for the first time in its brief. Petitioner advanced no evidence in support of this argument. The record does not show that the Division ever disallowed this amount, nor could I find any evidence that petitioner incurred these expenditures. Accordingly, petitioner has failed to carry its burden of proof on this issue.

I. With regard to penalties, petitioner argues that penalties should be abated because: (1) its underpayment of tax was based upon a reasonable interpretation of the law; and (2) it "voluntarily, properly and timely" filed the gains tax questionnaires.

Tax Law § 1446 (former [2][a]), in effect prior to 1989, provided as follows:

> "Any transferor failing to file a return or to pay any tax within the time required by this article shall be subject to a penalty of ten per centum of the amount of tax due plus an interest penalty of two per centum of such amount for each month of delay or fraction thereof after the expiration of the first month after such return was required to be filed or such tax became due, such interest penalty shall not exceed twenty-five per centum in the aggregate. If the tax commission determines that such failure or delay was due to reasonable cause and not due to willful neglect, it shall remit, abate or waive all of such penalty and such interest penalty."

The Division's 1986 amendments to Technical Services Bureau memorandum, Safe Harbor Estimate for Transfers Pursuant to Condominium and Cooperative Plans (TSB-M-86-[3]-R), provided guidelines for determining "safe harbor estimates" of anticipated taxes such that, in the event of underpayments, there would be no imposition of penalty or interest on the underpayments (see, Conclusion of Law "B"). However, even under "safe harbor reporting", the Division's Technical Services Bureau memorandum (TSB-M-86-[3]-R), provides, in pertinent part, that:

> "Penalty and interest may accrue during the Sell Out Period, however, for the underpayment of Gains Tax resulting from . . . the overstatement of original purchase price." (Emphasis added.)

Petitioner filed its initial gains tax transferor questionnaires in August 1987 (Petitioner's

brief, pp. 2-3). As noted in Conclusion of Law "B", each of the Technical Service Bureau Memoranda dealing with methods and guidelines for reporting and paying the subject tax were issued between 1983 and 1986, well before petitioner filed its initial transferor questionnaires (cf., Matter of Mattone v. Department of Taxation and Finance, supra). Petitioner has offered no evidence or argument to adequately explain or justify its failure to abide by the Tax Law and regulations, available at the time its gains tax schedules and questionnaires were filed. Contrary to petitioner's argument, this is not a reasonable legal position. By ignoring the Tax Law, regulations and Technical Service Bureau memoranda governing what can be included in computing original purchase price, petitioner's calculation overstated its original purchase price, understated the gains tax due, and warrants the imposition of penalty. Petitioner has failed to establish reasonable cause for abatement of penalty. The imposition of penalty and interest penalty is sustained.

J. The petition of Classic Residences, Inc. is granted to the extent set forth in Conclusion of Law "G" and is otherwise denied and the Notice of Determination issued on August 3, 1990, as modified by the Conciliation Order, is sustained.

DATED: Troy, New York
January 27, 1994

/s/ Carroll R. Jenkins
ADMINISTRATIVE LAW JUDGE